[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE REPUBLIC OF FINLAND

Scheduled for a Hearing

before the

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON JUNE 14, 1990

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty between the United States and the Republic of Finland ("Finland"). The proposed treaty was signed on September 21, 1989, and amplified by diplomatic notes signed the same day. The proposed treaty would replace the existing income tax treaty between the two countries that was signed in 1970. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on June 14, 1990.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), and the 1977 model income tax treaty of the Organization of Economic Cooperation and Development ("OECD model treaty"). However, there are certain substantive deviations from those documents. Among other things, the proposed treaty includes a number of provisions to accommodate aspects of the Tax Reform Act of 1986.

The first part of the pamphlet summarizes the principal provisions of the proposed treaty. The second part presents a discussion of issues raised by the treaty. The third part provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in part four by a detailed, article-by-article explanation of the proposed treaty.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the Republic of Finland* (JCS-15-90), June 13, 1990.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and Finland are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard treaty provisions that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 12, and 13). Generally, however, dividends, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10 and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit (Article 23).

The treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, the treaty contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Article 1); that is, the treaty will only be applied to the benefit of taxpayers.

Differences between proposed treaty, the present treaty, and model treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. and OECD model treaties. It also differs in significant respects from the present treaty with Finland. (The present treaty predated the 1981 U.S. model.) Some of these differences are as follows:

(1) The U.S. excise tax on insurance premiums paid to a foreign insurer is generally covered; that is, it is treated as a tax that may be reduced by the treaty. This is a departure from the present treaty and other older U.S. tax treaties, although similar coverage appears in some more recent treaties, such as the present treaties with France and Hungary. The excise tax on premiums paid to foreign insurers is covered under the U.S. model treaty.

(2) The U.S. excise taxes that are imposed with respect to private foundations are also generally covered. This too is a departure from the present treaty, but is consistent with the U.S. model treaty.

(3) Unlike the present treaty, the proposed treaty covers the church tax, an income tax imposed on members of the Evangelical Lutheran and Greek Orthodox churches and on corporations. Also unlike the present treaty, the proposed treaty does not cover the sailors' tax, a tax on wages and salaries of employees on Finnish seagoing merchant ships, and imposed in lieu of state income, communal, and church taxes and in lieu of national pension and sickness insurance premiums.

(4) The proposed treaty makes the saving clause reciprocal, while under the present treaty the saving clause by its terms only preserves internal law rules of the United States on its citizens and residents.

(5) Under the proposed treaty U.S. citizens or green card holders are not U.S. residents unless they have a substantial presence, a permanent home, or an habitual abode in the United States. The U.S. model, by contrast, covers all U.S. citizens. The United States has frequently been unable to negotiate coverage for nonresident citizens in its income tax treaties. Exceptions include treaties with Cyprus, Malta, Hungary, New Zealand, and Sweden.

(6) The residence-country "tie-breaker" rules of the present treaty for individuals who are dual residents are supplemented in the proposed treaty by a tie-breaker rule based on nationality of the dual resident. This is consistent with the U.S. model.

(7) The proposed treaty, like the U.S. model treaty, differs from the present treaty in that it does not treat a dual resident entity as a resident of the country under whose laws it was created. Instead, the competent authorities are to settle the question by mutual agreement. Generally, the laws of the United States and Finland would not operate to make a company a resident of both countries.

(8) The proposed treaty removes the clause of the present treaty providing that residents of one country are taxable by the other country only on income from sources in that other country (although the source rules of the present treaty give each treaty country the right to source income in many cases consistently with the scope of its taxing authority under the proposed treaty). The pro-

posed treaty is consistent with the U.S. model in this respect. The proposed treaty also removes or changes a number of source rules in the present treaty, which are discussed below where relevant.

(9) Unlike the present treaty, the proposed treaty defines a permanent establishment in strict conformity with the U.S. model. Thus, the proposed treaty adds a U.S. model treaty clause not contained in the present treaty dealing with drilling rigs and certain other similar items. It excludes from the definition of a permanent establishment the maintenance of a fixed place of business solely for the purposes of carrying on for the enterprise any activity of a preparatory or auxiliary character. It drops the specific exclusions for advertising, supply of information, scientific research, or similar activities which have a preparatory or auxiliary character. The proposed treaty also adds language identical to the U.S. model language, affirming that any combination of activities which singly do not constitute a permanent establishment will not together constitute a permanent establishment if their combination results in overall activity of a preparatory or auxiliary character. The language of the rules relating to the effect of permanent establishments of related enterprises and agents is also conformed to the U.S. model treaty.

(10) The proposed treaty generally conforms the definition of immovable (real) property to that in the OECD model treaty. The proposed treaty also contains a provision, not in the present or model treaties, under which income from the direct use, letting, or use in any other form of a right to enjoy immovable property, which right is held by a person by virtue of owning the shares of a company that holds the property, may by taxed by the country where the property is located. The proposed treaty also expands the present treaty (and U.S. model) definition of real property for these purposes to encompass "U.S. real property interests." This safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980, which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations. Both the U.S. model treaty and the proposed treaty provide for source country taxation of capital gains from the disposition of real property, regardless of whether the taxpayer is engaged in a trade or business in the source country.

(11) Like the present treaty, the proposed treaty does not contain the U.S. model treaty provision under which investors in real property in the country not of their residence, and who make an election to be taxed on those investments on a net basis, are bound by that election for all subsequent years unless the countries agree to allow the taxpayer to terminate it. Instead, the making of the election is controlled by internal law under the proposed treaty. Current U.S. law independently provides for elective net basis taxation, although the making of a second election under internal U.S. law is restricted once a first election has been revoked. Finnish law generally provides for such net-basis taxation without regard to any election. However, there are some exceptions to this rule.

(12) Unlike the present treaty and the U.S. model treaty, the proposed treaty excludes film and tape rental and license income from business profits, and instead treats them as royalties exempt from source country withholding tax. However, the effect of the pro-

posed treaty in this respect is generally the same as that of both the present and U.S. model treaties.

(13) The proposed treaty clarifies that a country may tax profits or gains if the other-country resident carries "or carried" on business, or has or had a fixed base, in that country. Addition of the words "or carried" clarifies that, for purposes of the treaty rules stated above, any income, gain or expense attributable to a permanent establishment (or fixed base) during its existence is taxable or deductible in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist. However, this language does not accommodate the application of Code section 864(c)(7) to a resident of Finland.

(14) The proposed treaty, like the present and model treaties, provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. However, unlike the U.S. model treaty, the proposed treaty does not include bareboat leasing profits in the category of profits to which this rule applies, unless those profits are incidental to profits from the operation of ships and aircraft in international traffic. Instead, they are covered by the business profits article. Like the U.S. model treaty and unlike the present treaty, the proposed treaty provides that profits of a treaty-country enterprise from the use or rental of containers and related equipment used in international traffic are taxable only in that country.

(15) The associated enterprises article of the proposed treaty conforms more closely than does the present treaty to the corresponding article in the U.S. model. In particular, the proposed treaty contains a "correlative adjustment" clause, and language expressly permitting the use of internal law standards such as section 482, neither of which are found in the present treaty. The correlative adjustment language provides that either treaty country must correlatively adjust any tax liability it previously imposed on an enterprise for profits reallocated to an associated enterprise by the other treaty country, if the first country agrees with the substance of the second country's adjustment. The corresponding U.S. model language is slightly different in that it does not condition the making of the correlative adjustment on the first country's *agreement* to the original adjustment made by the other country.

(16) Although Finland recently enacted tax reform and provided for corporate/shareholder integration through a shareholder imputation credit system, the proposed treaty provides no imputation benefits for U.S. persons.

(17) The proposed treaty permits a U.S. withholding tax of 15 percent on dividends if those dividends are paid by a regulated investment company (RIC), regardless of whether the RIC dividends are paid to a direct or portfolio investor. (This requires a reduction in the 30 percent statutory rate, and it applies even if the RIC dividend is received by a direct corporate investor, and is therefore exempt from Finnish tax under the double taxation article, as described below.) The proposed treaty eliminates the present treaty's reduction of U.S. withholding tax on dividends if those dividends are paid by a real estate investment trust (REIT), unless the dividend is beneficially owned by an individual Finnish resident hold-

ing a less than 10 percent interest in the REIT. The Senate recently gave advice and consent to protocols with France and Belgium on the understanding that provisions be negotiated with those countries permitting withholding rates on RIC and REIT dividends higher than the rates provided for in general by the U.S. treaties with those countries.

(18) Unlike the present treaty as interpreted by the Treasury Department, the proposed treaty permits the United States to impose the branch profits tax. The U.S. branch profits tax may be imposed at a rate not exceeding 5 percent. The proposed treaty also prevents imposition by one country of any other form of second-level withholding tax on dividend income of a resident of the other country from any company not resident in the first country, whether or not the company is subject to the branch profits tax. Under the present treaty, those dividends could be taxed by a treaty country if, in a prior 3-year period, 80 percent of the foreign company's gross income was industrial or commercial profits attributable to a permanent establishment in that country.

(19) The proposed treaty eliminates the provision of the present treaty that would permit imposition of a 15 percent source country tax, rather than only a 5 percent tax, on a dividend received from a company more than 25 percent of the income of which for the prior year was interest and dividends (other than interest from an active banking, insurance, or financing business or dividends from 50 percent subsidiaries). (But see the RIC rule described above in paragraph (17).) This change is consistent with the U.S. and OECD model treaties.

(20) Although the proposed treaty, like the present treaty, the U.S. model, and several U.S. treaties, generally provides for absence of source country taxation on interest, the proposed treaty provides that income from any arrangement, including debt obligations, carrying the right to participate in profits and treated as a dividend by the source country according to its internal laws, may be taxed by the source country as a dividend. Thus, for example, the country of source could withhold tax on an "equity kicker" in connection with a loan, at rates applicable to dividends. There is no similar provision in the present treaty or the U.S. or OECD models. In other respects the proposed treaty makes the interest definition more consistent with the U.S. model.

(21) The proposed treaty clarifies that, consistent with the exemption from tax at source on interest, no branch level interest tax on excess interest deductions (Code sec. 884(f)(1)(B)) will be imposed on a Finnish corporation with a U.S. permanent establishment.

(22) The proposed treaty eliminates the present treaty's interest source rule that restricted the operation of the U.S. rule, repealed in the 1986 Act, sourcing interest paid by a foreign corporation as domestic if the foreign corporation earned more than a threshold amount of income from U.S. sources. This change makes the proposed treaty more consistent with the post-1986 Act Code rules for taxing interest paid by branches of foreign corporations (Code sec. 884(f)(1)(A)).

(23) Unlike the model treaties and the present treaty, the proposed treaty permits the imposition of a 5 percent source country tax on "industrial" royalties, or royalties for the use of, or the

right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience. Under the present treaty, as well as the U.S. and OECD models, no source country tax is imposed on royalties.

(24) The proposed treaty adds a rule that sources royalties for the use of property in third countries by reference to the residence of the payor, and sources other royalties, consistent with U.S. internal law and treaty policy, by reference to the place of use.

(25) The proposed treaty contains a limitation on benefits article similar to the limitation on benefits articles contained in recent U.S. treaties and protocols and in the branch tax provisions of the Code. The present treaty contains a less detailed article, but one which denies benefits partly on the basis of the degree of residence country tax on a particular item of income.

(26) The proposed treaty generally conforms to the U.S. model treaty the provisions relating to independent personal services. Under the present treaty, income of a resident of one country from independent personal services performed in the other country can be taxed by the latter country only if the individual is present there over 183 days in the fiscal year concerned. Under the proposed treaty, the latter country can tax the income regardless of the number of days spent there, but only if the income is attributable to a fixed base regularly available to the individual in that country for the purposes of performing his or her activities.

(27) The portions of the dividend, interest, royalty, and gains articles of the present treaty which preserve the right of a treaty country in which a permanent establishment of a resident of the other country is situated to tax such income have been modified to also permit taxation by a country in which a fixed base is situated from which a resident of the other country performed independent personal services.

(28) The proposed treaty permits remuneration of a treaty country resident, employed as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of the other country, to be taxed by the latter country. This is similar to the OECD model provision, but differs from the present treaty, under which exclusive jurisdiction to tax such income is only given to a single treaty country if the ship or aircraft is also registered in the country of which the enterprise is a resident. This also differs from the U.S. model, under which only the employee's country of residence may tax his income from being the member of the regular complement of a ship or aircraft operated in international traffic. In addition, under the present treaty, unlike the proposed treaty, the country which is both the residence of the enterprise and the country of registry has exclusive jurisdiction to tax income of members of the regular complement of the ship or aircraft whether or not it is operated in international traffic.

(29) As is true of the U.S. model treaty, the proposed treaty generally allows source country taxation of an entertainer or athlete who earns more than $20,000 there during a taxable year, without regard to the existence of a fixed base or other contacts with the source country. The present treaty has no such provision. Unlike the corresponding article of the U.S. model, this article of the pro-

posed treaty refers to "sportsmen" rather than athletes. This is consistent with a recent proposal by the OECD for a change in its model.

(30) The proposed treaty provides for the treatment of child support payments, unlike the present treaty. Like the U.S. model treaty, the proposed treaty provides that child support is taxable only in the source country (i.e., the country of the payor's residence).

(31) The proposed treaty modifies the present treaty's prohibition on taxation by one treaty country of employment compensation paid by a government of the other treaty country, to a citizen of the other treaty country for services rendered in the discharge of a governmental function. The present treaty is in this respect similar to the U.S. model; the proposed treaty follows the OECD model. Under the proposed treaty, subject to the saving clause, remuneration other than a pension is taxable only by the paying country, or only by the residence country of the recipient if he or she is a national of that country, or did not become a resident of that country solely for the purpose of rendering the services. Pensions for such services are taxable only by the paying country, or only by the residence country of the recipient if he or she is a national of that country. Like the U.S. and OECD models, and numerous existing U.S. income tax treaties, the proposed treaty treats services rendered in connection with a business carried on by a government under the other personal services articles.

(32) The proposed treaty eliminates the provisions of the present treaty exempting from host country tax certain income from personal services earned by teachers, researchers, students, trainees, and other short-term visitors from the other country furthering their academic, technical, professional, or business experience in the host country. The proposed treaty retains the exemption from host country tax on payments arising outside the host country, received for maintenance, education, or training by a student, apprentice, or business trainee who is, or was immediately before the visit, a resident of the other treaty country and who is present in the host country for the purposes of his full-time education or training. The proposed treaty is consistent with the U.S. model.

(33) The proposed treaty eliminates certain rules in the present treaty, but not in the U.S. model treaty, applicable to the personal services income articles. These rules deal with reimbursed travel expenses, choice of article under which to seek benefits, and deductions for actual and deemed travel expenses of temporary visitors who qualify for exemption under the teachers, students, and trainees articles of the present treaty.

(34) The proposed treaty, unlike the present treaty, contains the standard "other income" article found in the model treaties and some existing treaties, such as the U.S. treaty with the United Kingdom, under which income not dealt with in another treaty article generally may be taxed only by the residence country when paid to a Finnish corporate direct investor.

(35) Both the present and proposed treaties preclude Finland from taxing certain dividends received by Finnish companies from U.S. companies. (In other cases, double taxation is eliminated in Finland, under both the present and proposed treaties, by credit.)

Under the present treaty, the exemption extends to all dividends paid by a U.S. corporation to a Finnish corporation which, under Finnish law, would have been exempt from Finnish tax if paid by a Finnish corporation. Under the proposed treaty, the exemption extends to any dividend paid by a U.S. resident company to a Finnish resident company that owns directly at least 10 percent of the voting stock of the former. Under this rule, for example, Finland collects no tax on dividends paid by corporations treated by the United States as pass-through entities (e.g., RICs and REITs) when paid to a Finnish corporate direct investor.

(36) The proposed treaty removes the rule in the present treaty, also provided in the model treaties, that the treaty cannot require the U.S. to give a credit for Finnish tax in excess of the proportion of income from Finnish sources.

(37) The present treaty clearly states that the United States need not give a credit against U.S. tax for the Finnish capital tax. The proposed treaty drops that language and otherwise raises an ambiguity as to the creditability against U.S. income tax of the Finnish capital tax.

(38) The proposed treaty provides a specific relief of double taxation rule for taxing citizens of one country resident in the other, unlike the present treaty. Under the so-called "three-bites-of-the-apple" rule applicable to U.S. citizens resident in Finland, the United States is required to provide a credit for Finnish tax imposed on U.S. income (resourcing the income if necessary to avoid double taxation). The Finnish tax credited, however, is limited to the amount that the treaty permits Finland to impose on a Finnish resident after the credits for U.S. tax on U.S. income. Under the rule applicable to a Finnish national resident in the United States but treated by Finnish law as a Finnish resident, Finland may tax that person but must give a credit for U.S. taxes.

(39) The proposed treaty modifies the nondiscrimination rule in the present treaty. The proposed treaty adds a clause, found in the U.S. model treaty, that for purposes of U.S. tax, a U.S. citizen not resident in the United States is not in the same circumstances as a Finnish national who is not a U.S. resident. The proposed treaty also adds the rule, found in the U.S. model, that precludes discrimination against the deductibility by a resident of one country of amounts paid to residents of the other country. In addition, the proposed treaty adds a clause, not found in the U.S. model, stating that nothing in the nondiscrimination article requires a treaty country to grant a company resident in the other country, but having a permanent establishment in the first country, a deduction from the profits attributable to the permanent establishment for dividends paid by the company. Finally, the proposed treaty clarifies that the nondiscrimination article does not prohibit imposition of the branch profits tax.

(40) The proposed treaty permits a treaty country to deny a refund arising out of a competent authority case unless that country was notified of the existence of the case within 6 years of the end of the taxable year at issue. This limit is not in the U.S. model or the present treaty, although a similar limit is in the U.S.-Canada treaty.

(41) Like the U.S. model treaty, the proposed treaty makes express provision for competent authorities to mutually agree on topics that would arise under the present treaty, but are not mentioned in the present treaty's mutual agreement article, such as the characterization of particular items of income, the common meaning of a term, the application of procedural aspects of internal law, and the elimination of double taxation in cases not provided for in the treaty. Also like the U.S. model, the proposed treaty makes express provision for competent authorities to mutually agree on topics that would arise only under the proposed treaty, namely, the dollar thresholds in the artistes and sportsmen article and the students and trainees provisions.

(42) The proposed treaty expands the exchange of information article of the present treaty to conform to the U.S. model provision.

II. ISSUES

The proposed treaty presents the following specific issues.

(1) Imputation credit

Finland has just begun to implement an "imputation" system of corporate/shareholder tax integration that provides relief to resident shareholders from the double taxation of corporate earnings. Shareholders resident in Finland who receive dividends from a Finnish corporation will gross up that dividend by 9/11ths of the dividend. The full dividend plus the gross-up will be included in income and taxed. However, a shareholder will be able to credit an amount equal to the gross-up against his tax liability. Nonresident shareholders do not receive the imputation credit under Finnish law, but may receive the benefit under treaties. The staff has been informed by the negotiators, however, that it is Finnish policy to grant the benefit only in treaties with imputation countries that provide a reciprocal benefit. Nonresident shareholders who do not receive this benefit under a treaty may be subject to a higher combined corporate and personal tax than a Finnish shareholder would be.

Some relief is granted to U.S. shareholders under the U.S. treaties with France and the United Kingdom, which also have imputation corporate tax systems, as well as under the pending U.S.-Germany treaty. The issue raised is whether the United States should insist on greater relief for its shareholders in Finnish companies. The reduction of the dividend withholding tax does provide some relief. However, the imputation credit may give Finnish shareholders a greater Finnish tax reduction than the withholding tax reduction gives comparable U.S. shareholders.

(2) Second-level withholding on dividends

Under current U.S. Code rules, a Finnish corporation engaged in the conduct of a trade or business in the United States would, in the absence of a treaty, be subject to a flat 30-percent branch profits tax on its "dividend equivalent amount." However, as interpreted by the Treasury Department, the present treaty, entered into before the enactment of the U.S. branch profits tax in 1986, prohibits imposition of the branch profits tax (Treas. Reg. sec. 1.884-1T(h).

For a case such as this where a treaty prevents imposition of the branch profits tax, the Code imposes U.S. withholding tax on a portion of the dividends paid by a foreign corporation to a foreign person, if 25 percent or more of the corporation's gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business. The U.S. source portion of such dividend is generally equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected

gross income to total gross income. This so-called second tier withholding tax is only imposed in the absence of a branch profits tax because both taxes accomplish a similar objective—namely, ensuring that, like the U.S earnings of U.S. corporations, the U.S. earnings of foreign corporations are subject to both corporate and shareholder level U.S. tax.

The present treaty restricts, but does not prohibit, the imposition of this so-called "second tier" withholding tax. Under the present treaty, this tax may only be imposed on a non-U.S. corporation if for the testing period, at least 80 percent of the corporation's gross income was industrial or commercial profits attributable to a U.S. permanent establishment.

The proposed treaty expressly permits the United States to impose the branch profits tax on a Finnish corporation, and forbids imposition of the second-tier withholding tax on a dividend paid by a Finnish corporation to a Finnish resident. The proposed treaty also forbids imposition of the second tier withholding tax on a dividend paid by a third-country corporation to a Finnish resident.

The issue is whether this favorable treatment of dividends paid by non-Finnish corporations under the Finnish treaty is appropriate. Corporations resident in many other countries with which the United States has treaties currently are not subject to the branch tax. This is not the preferred U.S. treaty position, and the Treasury Department is in at least some cases negotiating to permit the imposition of the branch tax on residents of these companies. At present, however, most U.S. treaties, as interpreted by the Treasury Department, do not permit imposition of the branch profits tax.

In light of the number of countries which have U.S. tax treaties protecting residents from the U.S. branch tax, and in light of the purposes of the second tier withholding tax, it would seem appropriate that a dividend paid by a corporation which is resident in neither Finland or the United States, to a resident of Finland, be subject to possible U.S. withholding tax, at least to the extent permitted under the present treaty, if the corporation is not subject to the U.S. branch tax due to a treaty. Yet under the proposed treaty, for example, a Dutch company doing business in the United States can pay dividends to a Finnish resident who has no U.S. permanent establishment or fixed base without incurring U.S. branch tax *or* U.S. dividend withholding tax.

The proposed treaty can be said to be flawed insofar as it treats such a dividend no differently than it treats a dividend paid by a Finnish corporation, which is subject to the U.S. branch tax. On the other hand, it may be argued that the Code's second tier withholding tax is already so far restricted under the present treaty that there is little to be gained by insisting on a reservation to the proposed treaty. The Committee may wish to express its views toward the proper method for relieving second tier withholding tax in future treaties.

(3) Royalties

Under the present treaty, similar to the U.S. and OECD model treaties, royalties are taxable only by the country of the recipient's residence, or by the source country in a case where the recipient

has a permanent establishment in that country with which the right or property giving rise to the royalties is effectively connected. Under the proposed treaty, "industrial royalties," or royalties for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience, may be taxed by the source country at a 5 percent rate. This rate increase was negotiated in response to Finland's initiative. The Treasury would have preferred to retain the zero withholding rule. The staff has been informed by the negotiators, however, that Finland is insisting on the change in all new and renegotiated treateis.

The issue is whether the United States should give back to Finland the right to tax Finnish source royalties paid to U.S. residents. Presumably, the Treasury Department believes that the United States obtained valuable concessions from Finland in exchange for its concession on the royalty issue. On the other hand, this concession to Finland may increase pressure on the United States to make similar ones in other renegotiations, or in negotiations of treaties with new income tax treaty partners. To date, the United States is a party to numerous treaties with other countries permitting 5 percent or more source country tax on industrial royalties; the United States is also a party to a lesser number of treaties that tax industrial royalties more heavily than other royalties.

(4) Allowance of U.S. credits for Finnish taxes

The Finnish capital tax is a covered tax under both the present and proposed treaties. The present treaty clearly states that the United States need not give a credit against U.S. tax for the Finnish capital tax. The proposed treaty drops that language. Moreover, in the article of the proposed treaty providing that the United States shall allow a credit against U.S. tax for income tax paid to Finland, the treaty further states that the capital taxes shall be considered income taxes. On the other hand, the proposed treaty provides that the United States shall provide a credit for the taxes paid to Finland only in accordance with U.S. tax laws. Under U.S. tax laws, the Finnish capital tax is not an income tax, and thus is not creditable against U.S. income tax. The Technical Explanation to the treaty prepared by the Treasury Department confirms that this is the result under the treaty.

The present treaty provides that the U.S. credit shall not exceed that portion of the United States tax which net income from Finnish sources bears to the entire net income. Thus, if any tax were creditable by virtue of the present treaty but not the Code, that tax could not be used to offset U.S. tax on foreign income from sources outside Finland. The U.S. model treaty provides for a similar result, stating that credits allowed solely by reason of the treaty, when added to otherwise allowable credits for treaty-covered taxes, shall not in any taxable year exceed that proportion of the U.S. tax on income which taxable income arising in the other country bears to total taxable income. The proposed treaty, by contrast, has no such rule. Thus, if Finnish capital taxes were creditable under the treaty against U.S. income tax of foreign source income, they

might be creditable against U.S. tax on non-Finnish, foreign source income.

The staff understands that the negotiators did not intend in the proposed treaty to provide U.S. foreign tax credits against U.S. income tax for Finnish capital taxes, or otherwise for taxes not creditable under U.S. domestic law. The Committee should assure itself that the proposed treaty is not interpreted or applied in a manner contrary to this intent.

(5) Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Finland and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of tax by lending money, for example, to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, including the treaties that are the subject of this hearing. Some aspects of the provision, however, differ either from the anti-treaty shopping provision of the U.S. model or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty shopping provision of the treaty effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the U.S. model and other U.S. treaties. The U.S. model allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter, under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article differs from the comparable rule of the U.S. model, but the effect of the change

is less clear. The general test applied by the U.S. model to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty gives the competent authorities the ability to override this standard. An informal Memorandum of Understanding exchanged by the negotiators, and reproduced in the Treasury's Technical Explanation of the proposed treaty, suggests some elaboration as to how these rules will be applied.

The practical difference between the proposed treaty tests and the U.S. model test will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty and Memorandum of Understanding could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty tests (i.e., would operate to deny benefits in potentially abusive situations more often).

The United States should maintain its policy of limiting treaty shopping opportunities whenever possible, and in exercising any latitude the Treasury Department has to adjust the operation of the bright-line rules of the treaty, it should satisfy itself that its rules adequately deter treaty shopping abuses. The present income tax treaty between the United States and Finland contains less sophisticated anti-treaty shopping rules. Further, the proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Finland since third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or Finnish residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. The base erosion test provides protection from certain potential abuses of a Finnish conduit. Finally, Finland imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Finnish entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the treaty and interpreted in the Memorandum of Understanding may raise factual, administrative, or other issues that cannot currently be foreseen. Thus, the Committee should satisfy itself that the provision as proposed is an adequate tool for preventing possible treaty-shopping abuses in the future.

(6) Insurance excise tax

The proposed treaty, unlike the present treaty, covers the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, a Finnish insurer or reinsurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. However, the tax is imposed to the extent that the risk is reinsured by the Finnish insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

Prior waivers of the excise tax have raised serious Congressional concerns. For example, concern has been expressed over the possibility that they may place U.S. insurers at a competitive disadvantage to foreign competitors in U.S. markets, if insubstantial tax is imposed by the other country to the treaty (or any other country) on the insurance income of its residents (or the income of companies with which they reinsure their risks). Moreover, in such a case waiver of the tax does not serve the purpose of treaties to avoid double taxation, but instead has the undesirable effect of eliminating all taxation.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Foreign Relations Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress. Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The waiver of the tax in the treaty with the United Kingdom (where the tax was waived without the so-called "anti-conduit rule") has been followed by a number of legislative efforts to redress perceived competitive imbalance created by the waiver.

The proposed treaty waives imposition of the excise tax on premiums paid to residents of Finland. Unlike Bermuda and Barbados, Finland imposes substantial tax on income of its residents. Unlike the U.K. waiver, moreover, the Finnish treaty waiver contains the standard anti-conduit language. The Committee may wish to assure itself that the practical effect of the waiver of the tax in this treaty is in fact to reduce double taxation, rather than to give Finnish insurers competing in the U.S. market a significantly more favorable overall tax burden than their U.S. counterparts.

(7) Tax on stock gains

The United States does not now impose tax on U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations, with primarily two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate. The proposed treaty further provides that gains of Finnish residents are exempt from U.S. tax unless they are gains from the disposition of U.S. real property interests, or gains from the alienation of personal proper-

ty which forms or formed part of the business property of a permanent establishment or a fixed base in the United States. Thus, if a Finnish resident without a U.S. permanent establishment or fixed base owns stock in a U.S. corporation, any gains from the disposition of that stock will be exempt from U.S. tax under the treaty, regardless whether U.S. internal law is changed to provide for such a tax, unless that change is intended to override existing treaties.

In 1989 the House of Representatives passed a bill that would have taxed the gain on a disposition by a foreign persons of stock in a U.S. corporation if the foreign person holds or held more than 10 percent of the stock of the U.S. corporation in the 5 years prior to the disposition. This provision, had it been enacted into law, would have yielded to contrary existing treaties for a 3 year period and then overridden them subsequently. In the committee report on this provision, however, it was anticipated that in some cases, it could have been desirable for the United States to enter into treaties that would modify the effect of the provision on treaty country residents.

The override provision was considered by the Administration to be a serious defect in the bill, putting aside the more basic tax policy question whether such gains of foreign persons should be exempt in all cases from U.S. tax, when dividends paid by U.S. corporations to foreign persons are not, or whether it would not be more appropriate to treat stock gains no more favorably than dividends.

Bills have been introduced this year in both Houses of Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person holds or held at least 10 percent of the stock of the domestic corporation.[2] Unlike the unsuccessful House bill provision of 1989, the 1990 bills generally do not override existing contrary treaties. The proposed treaty would thus prevent the operation of the bill vis-a-vis Finnish residents if the bill is passed.

The issue is whether it makes sense to enter into a treaty that forbids a tax that the Congress may decide to impose as the result of a change in its internal tax law policy. Although prior Congresses may have believed that the gains realized by foreign persons from the disposition of stock in U.S. companies were properly excluded, as a statutory matter, from the U.S. tax base, whether for reasons of administrability or for other reasons, Congress may decide that it is no longer appropriate to do so in the case of substantial foreign shareholders in U.S. companies. The Congress could further decide that, just as it is inappropriate in treaties to reduce source country taxation of dividends to zero, it is similarly inappropriate to reduce to zero the rate of tax on gain from stock that pays such dividends, or that it is inappropriate to reduce such tax to zero in all cases and for all types of dispositions.

Alternatively, the Congress could decide that, while a tax on stock gains should be imposed by statute, it may properly be waived in treaties, or at least treaties with countries that, in Con-

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[2] H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess. (1990).

gress's view, impose an adequate level of tax on the types of stock gains of its residents that would otherwise be subject to tax under the statute. As reflected in the OECD model and many existing treaties, for example, countries that do impose tax on the stock gains of foreign persons often waive such taxes in treaties, although because of differences in definitions of the term "gains" in other countries, those treaties may not operate in precisely the same manner as a U.S. income tax treaty, using U.S. definitions of the term "gain," would operate. (The U.S. model treaty also provides for waiver of the tax, but the U.S. model was last revised at a time when such a waiver would not have reduced any U.S. tax otherwise imposed by the Code, and thus could only have reduced foreign country taxes.)

Imposition of U.S. tax on U.S. stock gains of Finnish residents, and imposition of Finnish capital tax on Finnish stock of U.S. persons or Finnish income tax on Finnish stock gains of U.S. persons, are in many cases prohibited under the present U.S.-Finland income tax treaty. Continued prohibition of that tax in the proposed treaty may be seen by some as a benefit to U.S. taxpayers (or the U.S. fisc) at the expense of the Finnish fisc. Whether or not the Senate agrees to a new treaty with Finland, if Congress enacts the stock gains tax that the treaty protects Finnish residents from paying, it is unclear whether the United States and Finland would agree to retention or removal of the present treaty restriction on each country's ability to tax stock gains of foreign persons. Consideration might be given, by both parties to the treaty, to questions such as how the imposition or elimination of this tax is likely to affect the taxation by Finland of U.S. residents, as well as the taxation by the United States of Finnish residents.

The Committee might address this issue in alternative ways. First, the Committee could recommend that the Senate consent to the treaty notwithstanding this issue. It is not clear if or when Congress will enact a tax on foreign persons' stock gains; if Congress does not do so, then there will have been no need for the Committee to take notice of this issue. In addition, the Committee might conclude that the waiver contained in the proposed treaty is in the best interests of the United States and its residents when taking into consideration the level of investment and income flows between the United States and Finland.

Alternatively, if the Committee believed that it should preserve the right, in whole or in part, to tax Finnish persons' U.S. stock gains and that Finland should be free to tax in whole or in part U.S. persons' Finnish stock and stock gains, the Committee could seek a reservation allowing the United States to impose a tax on stock gains at a rate no less than that imposed on dividends, to limit the amount by which the tax on stock gains could be reduced, or to limit the cases in which it could be eliminated. This course, while it could allow the United States to collect the tax (if enacted, and if Finland agreed to ratify the treaty with such a reservation), could also present a condition that the Finnish Government finds unacceptable. Therefore, this course could delay or prevent the benefits of the treaty without affecting the present treaty's prohibition on imposition of the tax.

Third, the Committee could delay action on the treaty while it awaits legislative progress on the pending bills. This course would delay the time when taxpayers will be able to apply the rules of the proposed treaty to their transactions. Moreover, a failure to consent to the proposed treaty (or a failure to consent without reservations that the Finnish Government would not agree to) would leave the present treaty's prohibition on stock gain taxes in place.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income").

Income of a nonresident alien or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch level interest tax, which amounts to a flat 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien or foreign corporation (including generally interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is 1 or 4 percent of the premium paid. These taxes generally are collected by means of withholding (hence these taxes are often called withholding taxes).

These taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain exemptions from the 30-

percent tax are provided. For example, interest on deposits with banks or savings institutions is exempt from tax unless such interest is effectively connected with the conduct of a U.S. trade or business. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio obligations is exempt from the 30-percent tax. U.S. treaties also provide for exemption from tax in certain cases.[3]

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations are generally exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate.[4]

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are generally considered U.S. source income. Interest paid by the U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, then interest paid by that person will be foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test (an "80/20" company) are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period are not subject to U.S. withholding tax. Conversely, dividends and interest paid by a foreign corporation are generally treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend will be considered U.S. source income. The U.S. source portion of such dividend is generally equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be

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[3] Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited however, by the amount of tax-exempt interest paid to related persons.

[4] In addition, bills have been introduced in Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person held at least a threshold amount (i.e., 10 percent) of the stock of the domestic corporation (H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess. (1990)).

either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Pursuant to rules enacted as part of the Tax Reform Act of 1986 (the "1986 Act"), the overall limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Prior to the Tax Reform Act of 1984 (the "1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided lookthrough rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act proved that foreign tax credits cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, as amended by the Omnibus Budget Reconciliation Act of 1989, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations were a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels compara-

ble to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent tax and seeks to reduce this tax (on some income to zero) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause." Double taxation can also still arise because most countries will not exempt passive income from tax at the source.

This double taxation is mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law.

The objective of preventing tax avoidance and evasion is generally accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine informa-

tion, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further assured under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries without income tax treaties with the United States attempt to use a treaty to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

The treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against its enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Finland is presented below. Also presented below are explanations of the notes exchanged when the proposed treaty was signed. The notes are explained together with the articles of the proposed treaty to which they relate.

Article 1. Personal Scope

The personal scope article describes the persons who may claim the benefits of the proposed treaty and contains other rules regarding the general scope of the treaty, including the "saving clause."

The proposed treaty generally applies to residents of the United States and to residents of Finland, with specific exceptions designated in other articles (e.g., Articles 24 (Nondiscrimination) and 26 (Exchange of Information and Administrative Assistance)) and discussed below. This follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty. Residence is defined in Article 4.

The proposed treaty provides that it does not restrict any benefits accorded by internal law or by any other agreement between the United States and Finland. Thus, the treaty will apply only where it benefits taxpayers.

Like all U.S. income tax treaties, the proposed treaty is subject to a "saving clause." Under this clause, with specific exceptions described below, the treaty is not to affect the taxation by the United States of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Finland as if the treaty were not in force. "Residents" for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals who are not treated as residents of the other country under the treaty tie-breaker provisions governing dual residents (paragraphs 2 and 3 of Article 4 (Residence)).

Under Section 877 of the Internal Revenue Code (the "Code") a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The treaty contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens. Even absent a specific provision the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).

Exceptions to the saving clause are provided for certain benefits conferred by the treaty, namely: correlative adjustments to the

income of enterprises associated with other enterprises the profits of which were adjusted by the other country (Article 9, paragraph 2); reductions in taxation of child support (Article 18, paragraph 4); exemption from residence country tax (or in the case of the United States, citizenship country tax) on social security benefits and other public pensions paid by the other country (Article 18, paragraph 1(b)); relief from double taxation (Article 23); nondiscrimination (Article 24); and mutual agreement procedures (Article 25).

In addition, the saving clause does not apply to the following benefits conferred by one of the countries with respect to individuals who are neither citizens of the conferring country nor "lawful permanent residents" in the conferring country: exemption from tax on compensation from government service to the other country (Article 19)); exemption from tax on certain payments for the purposes of educating and supporting students, trainees, and business apprentices (Article 20); and certain fiscal privileges of diplomats referred to in the treaty (Article 27). The term "lawful permanent resident" is defined under the Code and generally has the same meaning as the term "immigrant status" used in the corresponding provision of the U.S. model treaty. For U.S. purposes, an individual has "immigrant status" in the United States if he has been admitted to the United States as a permanent resident under U.S. immigration laws (i.e., he holds a "green card").

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and Finland.

United States

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes. The proposed treaty also applies to the excise taxes with respect to private foundations and the excise tax on insurance premiums paid to foreign persons.

Under the Internal Revenue Code the United States imposes an excise tax on certain insurance premiums received by a foreign insurer from insuring a U.S. risk or a U.S. person (Code secs. 4371-4374). Unless waived by treaty, the excise tax applies to those premiums which are exempt from U.S. net basis income tax.[5] This insurance excise tax is covered by the proposed treaty, but only to the extent that the foreign insurer does not reinsure the risks in question with a person not entitled to relief from this tax under the proposed treaty or another U.S. treaty. The exchange of notes states an intent to develop procedures to ensure that this "anti-conduit" rule will be applied without undue administrative burden.

More specifically, income of a Finnish insurer from the insurance of U.S. risks or U.S. persons will not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exemption). This waiver applies

[5] Income from premiums earned by foreign persons may be exempt from U.S. net basis income tax either because it is not effectively connected with the conduct of a trade or business in the United States, or because of a treaty waiver of the net basis tax.

even if that insurance income is not attributable to a U.S. permanent establishment maintained by the Finnish insurer and hence not subject to U.S. net basis tax pursuant to the business profits article (Article 7) and other income article (Article 21). This treatment is a departure from the existing tax treaty with Finland, but is similar to that provided in some other recent U.S. tax treaties, for example, the treaties with France and Hungary, and the pending treaties with Germany, India, and Spain. The excise tax on premiums paid to foreign insurers is a covered tax under the U.S. model treaty.

Under the Internal Revenue Code (in the absence of a contrary treaty provision), a foreign insurer is subject to U.S. income tax on income derived from the insurance of risks situated in the United States in situations where that insurance income is effectively connected with a U.S. trade or business. A foreign insurer insuring U.S. risks ordinarily will not be viewed as conducting a U.S. trade or business and thus will not be subject to U.S. income tax if it has no U.S. office or agent and operates in the United States solely through independent brokers.

In these situations, a foreign insurer is not subject to U.S. income tax, but the insurance excise tax is imposed (except as otherwise provided in a treaty) on the premiums paid for that insurance.[6] The excise tax may be viewed as serving the same function as the tax imposed on dividends, interest, and other types of passive income paid to foreign investors. In general, the excise tax applies to insurance covering risks wholly or partly within the United States where the insured is (i) a U.S. person or (ii) a foreign person engaged in a trade or business in the United States. Under the Code, the excise tax generally applies to a premium on any such insurance unless the amount is effectively connected with the conduct of a trade or business in the United States and not exempt by treaty from the statutory net-basis tax.

The treatment of insurance income of foreign insurers is complicated somewhat in situations where, as is usually the case, some portion of the risk is reinsured with other insurers in order to spread the risk. In situations where the foreign insurer is engaged in a U.S. trade or business and thus subject to the U.S. income tax, reinsurance premiums, whether paid to a U.S. or a foreign reinsurer, are allowed as deductions. Accordingly, the foreign insurer is taxable only on the income attributable to the portion of the risk it retains. However, while generally no excise tax is imposed on the insurance policy issued by the foreign insurer doing business in the United States, the one-percent excise tax on reinsurance is imposed if and when that insurer reinsures that U.S. risk with a foreign insurer not subject to U.S. net-basis income tax.

In exempting from the U.S. income tax and the insurance excise tax all insurance income which is not attributable to a permanent establishment in the United States, the proposed treaty makes two changes in the statutory rules governing the taxation of insurance income of Finnish insurers. First, any insurance income which is

[6] The excise tax is currently imposed at a rate of four percent of the premiums paid on casualty insurance and indemnity bonds, and one percent of the premiums paid on life, sickness, and accident insurance, annuity contracts, and reinsurance (Code secs. 4371-4374).

effectively connected with a U.S. trade or business but is not attributable to a U.S. permanent establishment will not be subject to U.S. income tax. This exemption is contained in the existing treaty. Second, Finnish insurers not engaged in a U.S. trade or business will no longer be subject to the insurance excise tax. This exemption is not contained in the existing treaty. However, those Finnish insurers which continue to maintain a U.S. permanent establishment after the proposed treaty enters into force will remain subject to the U.S. income tax on their net U.S. insurance income attributable to the permanent establishment.

In addition, the insurance excise tax will continue to apply in situations where a Finnish insurer with a U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign reinsurer, other than a resident of Finland or another insurer entitled to exemption under a different tax treaty (such as the U.S.-France treaty). The tax liability may be imposed on the insurer which in this situation is viewed as the U.S. resident person transferring the premium to the foreign reinsurer. The excise tax will apply to such reinsurance even where the Finnish insurance company has a U.S. trade or business, but no U.S. permanent establishment, and thus will not be subject to U.S. *income* tax on the net income it derives on the portion of the risk it retains.

If the excise tax applies to premiums paid to the Finnish insurer in the absence of the treaty exemption, the tax will continue to apply to that insurer to the extent of reinsurance with a nonexempt person. For example, assume a Finnish company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a Danish insurance company (not currently entitled to exemption from the excise tax) and pays that Danish company a premium of $100. The four-percent excise tax on casualty insurance applies to the premium paid to the Finnish insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is four percent of the portion of its premium paid to the Finnish insurer which was used by the Finnish insurer to reinsure the risk. It is the responsibility of the U.S. insured to determine to what extent, if any, the risk is to be reinsured with a nonexempt person. Under an administrative procedure currently in effect, the burden of this responsibility effectively can be shared with the Finnish insurer (*see* Rev. Proc. 84-82, 1984-2 C.B. 779).

Finland

In the case of Finland, the proposed treaty, like the existing treaty, applies to the state income and capital tax, and the communal tax. The proposed treaty also applies to the church tax and the tax withheld at source from non-residents' income.

Other rules

For purposes of the nondiscrimination article (Article 24), the treaty applies to taxes of all kinds imposed by the countries, including any taxes imposed by their political subdivisions or local authorities. For purposes of the exchange of information article

(Article 26), the proposed treaty applies to national taxes of every kind imposed by the countries.

The proposed treaty also contains a provision generally found in U.S. income tax treaties (including the present Finland treaty) to the effect that it will apply to substantially similar taxes that either country may subsequently impose. While current and future Finnish capital tax on U.S. residents may be reduced by the treaty, any U.S. capital tax enacted in the future would not be "substantially similar" to U.S. taxes currently covered by the treaty, and therefore the imposition of such a tax on Finnish residents would not be reduced by the treaty. The diplomatic notes exchanged with the signing of the treaty provide that in the event the United States should enact a tax on capital that is comparable to the Finnish state capital tax, the United States will, without undue delay, enter into negotiations with Finland with a view to amending the treaty so as to cover the U.S. capital tax and to provide appropriate relief from double taxation of capital.

The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws and of any significant official published material concerning the application of the treaty, including explanations, regulations, rulings, or judicial decisions.

Article 3. General Definitions

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty.

The term "Finland" means the Republic of Finland and, when used in a geographical sense, means the territory in which Finnish tax law is in force.

The term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. Under Code section 638, where the term is used in a geographical sense, it includes the continental shelf; that is, the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Under the proposed treaty, therefore, these same areas are considered part of the United States for treaty purposes.

The term "person" includes an individual, an estate, a trust, a company, and any other body of persons. A "company" is any body corporate or any entity which is treated as a body corporate for tax purposes.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. The treaty does not define the term "enterprise."

A person is considered a Finnish national if the person is an individual possessing the nationality of Finland, or any legal person, partnership, and association deriving its status as such from the laws in force in Finland.

Under the proposed treaty a person is considered a U.S. national if the person is an individual U.S. citizen or any legal person, part-

nership, or association deriving its status as such from the law in force in the United States.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft except when the transport is solely between places in one of the contracting states. Accordingly, with respect to a Finnish enterprise, purely domestic transport in the United States is excluded.

The U.S. competent authority is the Secretary of the Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Assistant Commissioner (International). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

The Finnish competent authority is the Ministry of Finance or its authorized representative.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms not defined in the treaty are to have the meaning which they have under the laws of the country applying the treaty.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where, under the internal laws of the countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on his U.S. source income and on his income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. An individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes (i.e., a green card holder) also is a U.S. resident. The standards for determining residence provided in the Code do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States.)

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax therein by reason of his domicile, residence, place of incorporation, or any other criterion of a similar nature. However, the term "resident of a Contracting State" does not include any person who is liable to tax in that country in respect only of income from sources in that country. In addition, a U.S. citizen or U.S. green card holder is a U.S. resident only if the person has a substantial presence, permanent home, or habitual abode in the United States. "Substantial presence" is a defined term under the Code definition of residence in section 7701(b); "permanent home"

and "habitual abode" are terms frequently used in treaty "tie-breaker" rules, as described below. This result is contrary to U.S. treaty policy as expressed in the U.S. model, but the U.S. model result has been achieved in very few treaties.

A partnership, estate, or trust will be considered to be a resident of a country only to the extent that the income it derives is subject to that country's tax, either in its hands or in the hands of its partners or beneficiaries. For example, if the share of U.S. beneficiaries in the income of a U.S. trust is only one-half, Finland would have to reduce its withholding tax on only one-half of the Finnish source income paid to the trust.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. and OECD model treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not necessarily entitled to the benefits of the proposed treaty as U.S. residents.

A set of "tie-breaker" rules is provided to determine residence in the case of an individual who, under the basic residence rules, would be considered to be a resident of both countries. Such a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., his "center of vital interests." If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he shall be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a national. If he is a national of both countries or neither of them, the competent authorities of the countries are to settle the question of residence by mutual agreement.

In the case of a person other than an individual who is resident of both countries under the basic treaty definition, the treaty requires the competent authorities of the two countries to settle the question by mutual agreement and determine how the treaty applies to that person.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used

to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties will apply, or whether those amounts will be taxed as business profits. Taxation of business profits is discussed under Article 7 (Business Profits).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site or construction, assembly, or installation project, if the site or project lasts for more than 12 months. The use of an installation or drilling rig or ship in a treaty country to explore for or exploit natural resources constitutes a permanent establishment only if the use is for more than 12 months. The 12-month period for establishing a permanent establishment in connection with a site or project corresponds to the rule of the U.S. model treaty.

The general rule is modified to provide that a fixed place of business that is used for any of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise and the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. These activities include as well the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. Under the proposed treaty, a fixed place of business used solely for any combination of these activities will not constitute a permanent establishment; this specification is part of the U.S. model but is not included in the present Finnish treaty.

The proposed treaty omits language in the present treaty including in this class of activities as well the maintenance of a fixed place of business solely for the purpose of advertising, of the supply of information, of scientific activities, or of similar activities for the enterprise that have a preparatory or auxiliary character; this specification is not found in the U.S. or OECD models.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise will be deemed to have a permanent establishment in the first country. Consistent with the model treaties, this rule does not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment. Under the present treaty this exception only applies where the exercise of authority is limited to the purchase of goods or merchandise for the account of the enterprise. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or any other agent of independent status acting in the ordinary course of its business.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Such relationships are thus not relevant; only the activities of the company being tested are relevant.

Article 6. Income from Immovable (Real) Property

This article covers income from "immovable" (or for U.S. purposes, real) property. The rules covering gains from the sale of immovable property are in Article 13.

Under the proposed treaty, income derived by a resident of one country from immovable property situated in the other country may be taxed in the country where the immovable property is located. Income from immovable property includes income from agriculture or forestry.

The term "immovable property" has the meaning which it has under the law of the country in which the property in question is situated. For property situated in the United States, the term means "real property" as defined by U.S. law. The term in any case includes property accessory to immovable property; livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of immovable property; and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Thus, income from immovable property will include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). It does not include interest on loans secured by real property. Ships and aircraft are not real property.

The source country may tax income derived from the direct use, letting, or use in any other form of immovable property. These rules allowing source country taxation also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services. The proposed treaty also contains a provision, not in the present or model treaties, under which income from the direct use, letting, or use in any other form of a right to enjoy immovable property, which right is held by a person by virtue of owning the shares of a company that holds the property, may by taxed by the country where the property is located. This provision clarifies, for example, that income of a shareholder of an apartment cooperative from renting the apartment he uses by virtue of owning a share in the cooperative, may be taxed by the country in which the apartment is located.

The present treaty, the U.S. model treaty, and certain other U.S. income tax treaties provide residents of one country with an election to be taxed on a net basis by the other country on income from real property in that other country. The proposed treaty does not contain that election, but a net basis election is provided for U.S. real property income under the Code (secs. 871(d) and 882(d)). The staff understands that Finland generally provides for taxation of income from immovable property on a net basis. There are appar-

ently some exceptions, however, for some forestry and agricultural property; however, the rights of foreigners to own such property is believed to be very restricted.

Article 7. Business Profits

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate tax rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (thus it is said to be taxed as if it were business income under a limited "force of attraction" rule).

In the case of foreign persons other than insurance companies, foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For such persons, only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as such income is attributable to its United States business. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its world-wide operations and by the U.S. insurance industry.

Except in the case of a dealer, trading in stocks, securities, or commodities in the United States for one's own account does not

constitute a trade or business in the United States, and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S.-based employee, a resident broker, commission agent, custodian or other agent, or trading by a foreign person physically present in the United States.

The Code as amended by the Tax Reform Act of 1986 provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty rules

Under the proposed treaty, profits of an enterprise of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on, *or carried on,* business. This is one of the basic limitations on a country's right to tax income of a resident of the other country. The proposed treaty differs from the model treaties in using the term "profits" rather than "business profits." The present treaty uses the term "industrial or commercial profits." No substantive difference attaches to this semantic variation between the proposed and model treaties.

The proposed treaty also differs from the model treaties in permitting a country to tax profits if the other-country resident carries "or carried" on business in that country. Addition of the words "or carried" clarifies that, for purposes of the treaty rules stated above, any income, gain or expense attributable to a permanent establishment (or fixed base) during its existence is taxable or deductible in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Profits from U.S. source income other than U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains, are treated as effectively connected with the conduct of a trade or business in the United States, and taxed as such by the United States, without regard to whether they were derived from business activities or business assets.

Under the proposed treaty, by contrast, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there are to be attributed to a permanent establishment the business profits which would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions. For example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed to the permanent establishment whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses and other expenses. This language differs from the U.S. model, which expressly lists research and development expenses, and interest expenses. However, no substantive difference from the model is intended. Thus, for example, a U.S. company which has a branch office in Finland but which has its head office in the United States will, in computing the Finnish tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in the United States by the head office for purposes of operating the Finnish branch.

In the case of a resident of the United States with permanent establishments in more than one Finnish municipality, the resident may be subject to more than one communal tax (that is, Finnish municipal income tax), in which case profits must be allocated and apportioned among the permanent establishments in computing the communal taxes. The diplomatic notes exchanged on the signing of the treaty provide that for communal tax purposes the aggregate Finnish profits of a U.S. enterprise (that is, the business profits of the enterprise that are attributable in the aggregate to one or more permanent establishments in Finland) are to be determined in accordance with this article. However, where the enterprise has more than one permanent establishment in Finland, this article does not preclude Finland from determining the portion of the enterprise's aggregate Finnish profits allocable to each municipality as may be customary for that purpose in Finland. Any apportionment method adopted, however, must yield a result in accordance with the principles of this article.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities.

Under the proposed treaty, the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment.

Thus the proposed treaty departs from the limited force of attraction rule in the Code described above. The proposed treaty is consistent with the model treaties and other existing U.S. treaties in this respect. The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

The treaty restricts the application of the 1986 Act U.S. rule for taxing the gain on property previously used or held for use in connection with the conduct of a trade or business in the United States (Code sec. 864(c)(7)). There is no U.S. or OECD model provision permitting imposition of the U.S. rule addressed by this paragraph of the proposed protocol. The single U.S. treaty that has been updated by provisions now in force to take into account the 1986 Act amendments, namely, the U.S.-France treaty, does not permit imposition of the rule. Nor does the pending treaty with Tunisia. The pending treaties with Germany and Spain would permit a restricted imposition.

For purposes of the proposed treaty, the term "profits" means income derived from any trade or business, including the rental of tangible personal property, but not including the rental or licensing of cinematographic films and films or tapes used for radio or television broadcasting. (Those items are treated as royalties under the royalties article (Article 12).) The U.S. model treaty definition includes income from such rental or licensing of films and tapes in the term business profits. However, because the royalties article of the proposed treaty would allow taxation of royalty income only by the country of the recipient's residence, or the country in which the recipient has a permanent establishment (or fixed base) with which the property underlying the royalty is effectively connected, it is understood that in fact the result under the proposed treaty is not different, in general, from the result under the U.S. model.

Where profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not the business profits article, will govern the treatment of those items of income. Thus, for example, dividends are taxed under the provisions of Article 10 (Dividends), and not as business profits, except as provided in paragraph 4 of Article 10.

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation of ships and aircraft, and profits from the use or rental of containers, trailers, barges, and related container transport equipment, in international traffic. The rules governing income from the sale of ships, aircraft, and containers are in Article 13 (Gains).

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

Under the proposed treaty, profits which are derived by an enterprise of one country from the operation in international traffic of

ships or aircraft ("shipping profits") will be exempt from tax by the other country, regardless of the existence of a permanent establishment in the other country. International traffic means any transport by ship or aircraft, except where the transport is solely between places in one of the countries (Article 3(1)(g) (General Definitions)). Unlike the exemption provided in the present treaty, the exemption in the proposed treaty applies whether or not the ships or aircraft are registered in the first country. Thus, for example, Finland would not tax the income of a U.S. resident operating a Liberian-flag vessel.

As is true of some other existing U.S. treaties, the proposed treaty does not provide protection from source country taxation of income from bareboat leases of ships or aircraft in international traffic to the same extent as the U.S. model treaty, which exempts such income from source country tax as income from the operation of ships or aircraft in international traffic. For example, the model provides exemption in the source country for a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic but that leases ships or aircraft for use in international traffic. Under the proposed treaty the exemption for shipping profits does not apply to profits from the rental on a bareboat basis of ships or aircraft unless those profits are incidental to profits from shipping income. A taxpayer such as a financial institution or a leasing company that does not operate ships or aircraft would thus look to the business profits article for the rules governing the rental income (as it would be income from the rental of tangible personal property (Article 7, paragraph 7)), and as such exempt from tax by the source country unless attributable to a permanent establishment in that country.

The exemption does apply to income derived from the use, maintenance, or rental of containers, trailers for the inland transportation of containers, barges, and other related equipment used in international traffic. In addition, the shipping and air transport provisions apply to profits from participation in a pool, joint business, or international operating agency, assuming that the other provisions of the treaty (e.g., the limitation on benefits article (Article 28) or paragraph 1(b) of Article 3 (Residence), relating to treaty benefits for income of partnerships, trusts, and estates) permit such application.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's length pricing provision similar to section 482 of the Code which recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises are also related

if the same persons participate directly or indirectly in their management, control, or capital.

The proposed treaty states that this provision is not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related persons when necessary in order to prevent the evasion of taxes or clearly to reflect the income of those persons. Thus, the proposed treaty makes clear that the United States retains the right to apply its inter-company pricing rules (Code section 482, including, it is understood, the "commensurate with income" standard for pricing transfers of intangibles) and its rules relating to the allocation of deductions (Code sections 861, 862, and 863, and applicable regulations).

When a redetermination of tax liability has been properly made by one country, and the other country agrees to its propriety, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. This "correlative adjustment" clause has no counterpart in the present treaty. Its language differs from the corresponding U.S. model treaty language insofar as the correlative adjustment is only required to the extent that the other country *agrees* with the original adjustment by the first country. In making that adjustment, due regard is to be given to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary. For example, under the mutual agreement article (Article 25), a correlative adjustment cannot necessarily be denied on the ground that the time period set by internal law for claiming a refund has expired. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship will not apply in the case of such adjustments.

Article 10. Dividends

In general

The proposed treaty replaces the dividend article of the present treaty with a new article that makes several changes. First, the proposed treaty permits exceptions to the general 5 percent and 15 percent source country tax rates on dividends from a regulated investment company (RIC) or real estate investment trust (REIT). Second, the proposed treaty permits the application by the source country of the treaty's dividend tax rates to income from arrangements, including debt obligations, carrying the right to participate in profits. Third, the proposed treaty permits the imposition of the branch profits tax in lieu of any other second-level withholding tax on dividends from a foreign corporation.

Internal dividend and branch profits taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S. source dividends (other than dividends paid by an "80/20 company" described in Code section 861(c)) paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a

trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates, on a net basis.

In addition, a foreign corporation engaged in the conduct of a trade or business in the United States is subject to a flat 30 percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business.

U.S. source dividends are generally dividends paid by a U.S. corporation. Also treated as U.S. source dividends for this purpose are portions of certain dividends paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business. The U.S. source portion of such dividend is generally equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to its total gross income. No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax. The tax imposed on the latter dividends is often referred to as the "second tier" withholding tax.

In general, corporations do not receive deductions for dividends paid under U.S. law. Thus, the withholding and branch taxes often represent imposition of a second level of tax on corporate taxable income. Treaty reductions of these taxes reflect the view that where, for example, the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source country taxation. Moreover, the 5 percent rate reflects the view that the source country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

REIT is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met (Code sec. 857(b)). One of those conditions is the requirement that a REIT distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. Often, the principal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution of earnings is treated as a dividend, rather than income of the same type as the underlying earnings. This is true even though the REIT generally is not taxable at the entity level on the earnings it distributes. Because a REIT cannot be engaged in an active trade or business, its distributions are U.S. source and are thus subject to U.S. withholding tax of 30 percent when paid to foreign owners. Distributions of rental income, for example, are not themselves considered rental income. Like dividends, U.S. source rental

income of foreign persons is generally subject to U.S. withholding tax at a statutory rate of 30 percent (unless, in the case of rental income, the recipient elects to have it taxed in the United States on a net basis at the regular income tax rates). Unlike the tax on dividends, however, the withholding tax on rental income is generally not reduced in U.S. income tax treaties.

The Internal Revenue Code also generally treats RICs as both corporations and conduits for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

Finland

At present, Finland imposes by internal law a 25-percent withholding tax on Finnish source dividends paid to nonresidents, and provides reductions for dividends paid to treaty country residents. Under prior law, Finland provided a degree of "integration," or relief from the taxation of corporate earnings at both the corporate and individual shareholder levels, through allowance of a deduction for dividends paid. Effective for 1990, Finland will be using an imputation system to integrate the corporate and individual tax burdens. Finnish resident shareholders will receive an imputation credit for the corporate-level distribution burden. The credit will be applied against the shareholder's Finnish income tax liability or, if the credit exceeds the liability, the excess will be refunded to the shareholder. In the absence of a tax treaty, nonresidents of Finland will not receive the imputation credit. This imputation system was introduced into the Finnish tax laws in 1988.

Under the Finnish tax system, the taxable income of a branch of a foreign corporation is taxable at the same flat rate as the taxable income of a Finnish company.

Treaty reduction of dividend taxes

Under the proposed treaty, each country may tax dividends paid by its resident companies, but the rate of tax is limited by the treaty if the beneficial owner of the dividends is a resident of the other country. Source country taxation is generally limited to five percent of the gross amount of the dividends if the beneficial owner of the dividends is a company which holds directly at least 10 percent of the voting shares of the payor corporation. The tax is generally limited to 15 percent of the gross amount of the dividends in other cases involving dividends paid to residents of the other country.

The prohibition on source country tax in excess of 5 percent on direct investment dividends does not apply to a dividend from a RIC or REIT. Thus, the proposed treaty allows the United States to impose a 15 percent tax on a U.S. source dividend paid by a RIC to a Finnish company owning 10 percent or more of the voting shares of the RIC. In addition, there is no limitation in the proposed treaty on the tax that may be imposed by the United States on a dividend paid by a REIT to a Finnish resident, if the recipient is either an individual holding a 10 percent or greater interest in the REIT, or a company. Such a dividend would thus be taxable by the

United States, assuming no change in present internal law, at the full 30 percent rate.

The limitations on source country taxation of dividends do not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Definition of dividends

The proposed treaty provides a definition of dividend that is similar to the definition in the U.S. model treaty and some U.S. treaties. Like the U.S. model treaty, the proposed treaty generally defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. Dividends also include income from other rights that is subjected to the same tax treatment as income from shares by the country in which the distributing corporation is resident. The proposed treaty also provides (unlike the U.S. model treaty) that the term dividends includes income from arrangements, *including debt obligations,* carrying the right to participate in profits, to the extent so characterized under the law of the source country. Thus, the treaty would permit dividend treatment of an "equity kicker" amount that is paid on a loan.

Special rules and exceptions

The proposed treaty's reduced rates of tax on dividends will not apply if the dividend recipient has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the shareholding on which the dividends are paid forms part of the permanent establishment (or fixed base). Dividends paid on shareholdings of a permanent establishment are to be taxed as business profits (Article 7). Dividends paid on shareholdings of a fixed base are to be taxed as income from the performance of independent personal services (Article 14).

The proposed treaty contains a general limitation on the taxation of dividends paid by corporations which are not residents of that country. Under this provision, Finland may not impose any taxes on dividends paid by a non-Finnish corporation except where the dividends are paid to Finnish residents or are attributable to a permanent establishment or fixed base of the beneficial owner of the dividends in Finland. Similarly, the United States may not impose any tax on dividends paid by a non-U.S. corporation except where the dividends are paid to a resident or citizen of the United States or where the dividends are attributable to a permanent establishment or fixed base in the United States.

Branch profits tax

The proposed treaty would expressly permit the United States to collect the branch profits tax from a Finnish company, and would permit Finland to collect a similar tax from a U.S. company. Finland currently imposes no such tax.

The Code as amended by the 1986 Act imposes branch level taxes on foreign corporations earning income effectively connected with the conduct of a U.S. trade or business. The Code provides that no U.S. treaty shall exempt any foreign corporation from the branch

profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country.

The Code defines a "qualified resident" as any foreign corporation which is a resident of a treaty country if can meet at least one of the following tests. First, any foreign corporation resident in a treaty country is a qualified resident of that country unless 50 percent or more (by value) of the stock of the corporation is owned (directly or indirectly within the meaning of Code section 883(c)(4)) by individuals who are not residents of the treaty country and who are not U.S. citizens or resident aliens, or 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the treaty country or the United States. Second, a foreign corporation resident in a treaty country is a qualified resident if the stock of the corporation is primarily and regularly traded on an established securities market in the treaty country, or if the corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in the treaty country and the stock of which is so traded, or is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States.

The proposed treaty would allow the United States to impose the branch profits tax (as opposed to the branch level interest tax (Code sec. 884(f)) on a Finnish corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from immovable property or gains from the disposition of real property interests. The treaty would also allow Finland to impose a branch profits tax on similar items earned by a U.S. corporation. However, the proposed treaty permits at most a 5 percent branch tax rate, and, in cases where a corporation resident in one treaty country conducts a trade or business in the other country, but not through a permanent establishment, the proposed treaty would prohibit imposition of the branch profits tax on such corporation (other than in connection with real property income or gains).

The U.S. tax may be imposed only on that portion of the business profits of the Finnish corporation attributable to its U.S. permanent establishment, and that portion of the corporation's real property income and gains, which represents the "dividend equivalent amount" of those profits as that term is defined under U.S. law as it may be amended from time to time without changing its general principle. (Currently the dividend equivalent amount of business profits attributable to a permanent establishment generally is the earnings and profits attributable to a U.S. permanent establishment, plus an additional amount representing any decreases in the permanent establishment's "U.S. net equity" and minus an amount representing any increase in the permanent establishment's U.S. net equity.) None of the restrictions on the operation of U.S. or Finnish internal law branch tax provisions apply, however, unless the corporation seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 16). As described in the discussion of Article 16 below, the limitation on benefits requirements of the proposed treaty are very similar, but not identical, to the analogous provisions of the branch profits tax provisions of the Code described above.

The proposed treaty would allow Finland to impose a branch profits tax only on that portion of the business profits of a U.S. corporation attributable to its Finnish permanent establishment, and that portion of the corporation's real property income and gains, that if the operation was carried on by a subsidiary incorporated in Finland would be distributed as a dividend.

Article 11. Interest

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short term original issue discount), the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. U.S. source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets the foreign business requirements of Code section 861(c) (e.g., an 80/20 company). Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is also subject to a branch level interest tax, which is the tax it would have paid had a wholly owned domestic corporation paid it the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business. Finland has a 30 percent tax on interest derived in Finland by nonresidents which, like the corresponding U.S. tax, is frequently eliminated under various internal-law exceptions.

The proposed treaty generally provides that interest derived and beneficially owned by a resident of a country may be taxed only by that country. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax on U.S. source interest paid to foreign persons, interest paid to Finnish residents, and exempts from Finnish taxes interest paid to U.S. residents. The excess of the amount of interest deductible by a U.S. permanent establishment of a Finnish company over the interest actually paid by the permanent establishment is treated as interest derived and beneficially owned by a Finnish resident. Therefore, the proposed treaty exempts Finnish corporations from imposition by the United States of the branch level interest tax. These reciprocal exemptions are similar to those provided under the present treaty and the U.S. model treaty.

The exemptions apply only if the interest is beneficially owned by a resident of one of the countries. Accordingly, they do not apply if the recipient of the interest is a nominee for a nonresident. In addition, the exemptions will not apply if the recipient has a permanent establishment or fixed base in the source country and the debt claim is effectively connected with the permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by holding that the amount of interest for purposes of applying this article will be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty.

For example, excess interest paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Subject to an exception added by the proposed treaty, the treaty defines interest as income from debt claims of every kind, whether or not secured and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures, as well as all other income that is treated as income from money lent by the tax law of the source country. However, under the exception, interest does not include payments from arrangements, including debt obligations, carrying the right to participate in profits that are characterized by the laws of the source country as dividends. Penalty charges for late payment also are not interest for purposes of the proposed treaty.

Article 12. Royalties

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangible assets in the United States. Such royalties include motion picture royalties. Finland has a 30 percent tax on royalties derived by nonresidents.

The proposed treaty provides that royalties derived and beneficially owned by a resident of a country generally may be taxed only by that country. However, in a departure from this general rule, and a departure from the present treaty and the U.S. and OECD model treaties, the proposed treaty permits the imposition of a 5 percent source country tax on royalties for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience. Under the present treaty, as well as the U.S. and OECD models, no source country tax may be imposed on royalties.

Thus, the proposed treaty generally exempts from the U.S. 30-percent tax on U.S. source royalties paid to foreign persons royalties paid to Finnish residents, and exempts from Finnish tax royalties paid to U.S. residents, in the case of royalties for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematographic films and films or tapes for radio or television broadcasting. Under the U.S. model treaty, such income from films and tapes would be subject to the business profits article.

The exemptions and rate reductions apply only if the royalty is beneficially owned by a resident of the other country; they do not apply of the recipient of the royalty is a nominee for a nonresident.

In addition, the exemptions will not apply where the recipient is an enterprise with a permanent establishment in the source country or an individual performing personal services in an independent capacity through a fixed base in the source country, and the property giving rise to the royalty is effectively connected with the

permanent establishment or fixed base. In that event, the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by holding that the amount of royalties for purposes of applying this article will be the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty, for whatever reason, will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Royalties are defined to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematographic films and films or tapes for radio or television broadcasting; for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property; or for information concerning industrial, commercial, or scientific experience. The term "royalties" also includes gains from the alienation of a right or property described above which are contingent on the productivity, use, or further alienation of such right or property.

The proposed treaty provides special source rules for royalties. Generally under U.S. tax rules (section 861-862), royalty income is sourced where the property or right is being used. The treaty retains this rule, but applies other rules when this rule does not create a source in the United States or Finland. For example, if a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, or by a resident of one of the countries, then the income will generally be sourced in the country of residence of the payor if the place of use test does not produce a U.S. or Finnish source.

Article 13. Gains

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property.

Under the proposed treaty, gains from the disposition of immovable or real property may be taxed in the country where the immovable property is situated. Immovable property for the purposes of this article includes immovable property referred to in article 6 (Income for Immovable (Real) Property). Immovable property situ-

ated in the United States includes a U.S. real property interest. The proposed treaty thus allows the United States to tax transactions of Finnish residents taxable under FIRPTA. Immovable property situated in Finland includes shares or other corporate rights in a company the ownership of which entitles a person to the enjoyment of immovable property held by the company.

Gains from the alienation of movable (personal) property which forms part of the business property of a permanent establishment which an enterprise of one country has or had in the other country, or gains from the alienation of movable property pertaining to a fixed base which is or was available to a resident of one country in the other country for the purpose of performing independent personal services, including gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base, may be taxed in that other country.

The wording of the above rule varies somewhat from the U.S. model treaty to clarify that any gain attributable to a permanent establishment (or fixed base) during its existence is taxable in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist. Thus, the proposed treaty gives a taxing right to a country in which the other country's resident has *or had* a permanent establishment; the proposed treaty further gives a taxing right a country in which a fixed base is *or was* available to the other country's resident. However, this language does not conform the treaty with the rules of Code section 864(c)(7), as described above in connection with Article 7 (Business Profits).

Gains from the alienation of ships, aircraft, or containers operated by an enterprise of one country in international traffic are taxable only in that country. Gains from the alienation of a right or property which are contingent on the productivity, use, or disposition thereof are treated under Article 12 as royalties and are taxable only under that article.

Gains from the alienation of any property other than that discussed above will be taxable under the proposed treaty only in the country where the alienator is a resident.

Article 14. Independent Personal Services

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) is treated separately from income from the performance of dependent personal services.

Income from the performance of independent personal services in one country by a resident of the other country will be exempt from tax in the country where the services are performed (the source country) unless the individual performing the services has a fixed base regularly available to him in that country for the purpose of performing the services. In that case, the source country can tax only that portion of the individual's income which is attributable to the fixed base.

The proposed treaty provides a different exemption from source country tax for income from independent personal services than the present treaty. Under the present treaty, an exemption from tax in one country is available to a resident of the other country if his stay in the first country does not exceed 183 days in the fiscal year concerned. On the other hand, the present treaty does not contain the fixed base limitation found in the proposed treaty.

The exemption from source country tax provided in the proposed treaty for independent personal services income is similar to that contained in the U.S. model treaty.

It is understood that no change to the model treaty language is necessary to conform the treatment of income derived from independent personal services with Code section 864(c)(6), under which, as described above, any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year. An analogous rule applies to income for a taxable year from independent personal services performed in another year in which a fixed base was available.[7]

Article 15. Dependent Personal Services

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is excluded from U.S. source income, and therefore not taxed by the United States, if certain criteria are met. The criteria are: (1) the individual is not in the United States for over 90 days during a taxable year, (2) the compensation does not exceed $3,000, and (3) the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign office or place of business of a U.S. person.

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during the calendar year concerned; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base

[7] If a treaty country resident receives income for independent activities rendered by that resident, and the activities were performed in the other treaty country in a year during which the resident was present in the second country for more than 183 days (or the resident maintained a fixed base in the second country for more than 183 days), then that income is taxable by the second treaty country, regardless of whether payment for the activities was deferred to years in which the resident had no presence in the second country. *See* Rev. Rul. 86-145, 1986-2 C.B. 297.

of the employer in the source country. This degree of limitation on source country taxation is consistent with the present treaty, as well as the U.S. and OECD models.

The proposed treaty provides that compensation derived from employment as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of a treaty country may be taxed in that country. This differs from the U.S. model, which permits only the country of the employee's residence to tax the income. It also differs somewhat from the present treaty, which provides that only the country of the enterprise's residence may tax the income, as long as the ship or aircraft is registered in that state.

This article is modified in some respects for pensions (under Article 18) and income from government service (under Article 19). The article is consistent with the corresponding article of the U.S. model treaty.

Article 16. Limitation on Benefits

The proposed treaty contains a provision, which takes the place of article 27 of the present treaty (Investment or Holding Companies), intended to limit the benefits of the treaty to persons who are entitled to them by reason of their residence in the United States or Finland.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Finland as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping" and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed new anti-treaty shopping article provides that a person other than an individual (for example, a corporation, partnership, trust, or other business organization) is not entitled to the benefits of the treaty unless it satisfies an ownership/"base erosion" test, a public company test, or a good business purpose test, or unless it is itself one of the treaty countries or a political subdivision or local authority thereof, or else is a not-for-profit, tax exempt organization that also satisfies an ownership test.

Under the ownership/base erosion payment test, more than 50 percent of the beneficial interest (in the case of a company, more

than 50 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more individual residents of Finland or the United States, citizens of the United States, certain publicly traded companies (as described in the discussion of the public company test below), the countries themselves, political subdivisions or local authorities of the countries, or certain tax-exempt organizations (as described in the discussion of qualifying organizations below). This rule would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends or royalties paid to a Finnish company that is controlled by individual residents of a third country. This rule is not as strict as that contained in the U.S. model, which requires 75 percent ownership by residents of the person's country of residence, to preserve benefits.

In addition, the ownership/base erosion test is met only if no more than 50 percent of the gross income of the entity is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities other than those just named. This rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing (including paying, in the form of deductible items such as interest, royalties, service fees, or other amounts) most of its income to persons not entitled to benefits under the treaty. This provision is substantially similar to that in the U.S. model treaty.

Under the public company test, a company that is a resident of Finland or the United States and that has substantial and regular trading in its principal class of stock on a recognized stock exchange is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes. The term "recognized stock exchange" includes the NASDAQ System owned by the National Association of Securities Dealers, Inc. in the United States; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; the Helsinki stock Exchange; and any other stock exchange agreed upon by the competent authorities of the two countries.

Under the good business test, treaty benefits will be available under the proposed treaty to an entity that is a resident of the United States or Finland, the ownership/base erosion and public company tests notwithstanding, if it is engaged in the active conduct of a trade or business in its residence country, and the income derived from the other country is derived in connection with, or is incidental to, that trade or business. However, this exception does not apply (and benefits are therefore denied) to the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. This active trade or business rule replaces a more general rule in the U.S. model treaty and some other U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty.

A Memorandum of Understanding was discussed by the negotiators, suggesting the method by which the good business standard, and another aspect of the article discussed below, may be interpreted. The memorandum provides several examples of situations in

which the good business purpose test would be considered to be met and examples where it would not be met. Under one example, the Memorandum of Understanding states that U.S. source interest income on short-term investments of earnings, retained as working capital, of an active Finnish business carried on by a Finnish company, is incidental to the Finnish business and therefore eligible for treaty benefits on that basis. As another example, the Memorandum of Understanding states that if a third-country resident establishes a Finnish company for the purpose of acquiring a large U.S. manufacturing company, and the Finnish company's only other activity is the operation of a small retailing outlet which sells products manufactured by the U.S. company, dividends from the U.S. company would not be entitled to benefits. In this case, despite an arguable business connection between the U.S. and Finnish businesses, the active Finnish business is not substantial in relation to the business of the U.S. subsidiary.

An entity will also be entitled to benefits under the proposed treaty if it is a not-for-profit organization that, by virtue of that status, is generally exempt from income taxation in its treaty country of residence, provided that more than half the beneficiaries, members, or participants, if any, in the organization are entitled to the benefits of the treaty.

Finally, the treaty provides a "safety-valve" for a treaty country resident that has not established that it meets one of the other more objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country so determines. Under the principles of the Memorandum of Understanding, all relevant facts and circumstances will be taken into account by a competent authority under this provision, including: the existence of a clear business purpose for the structure and location of the income earning entity in question; the conduct of an active trade or business (as opposed to a mere investment activity) by the entity; and a valid business nexus between that entity and activity giving rise to the income. They are also to consider whether and to what extent a substantial headquarters operation conducted in a treaty country by employees of a resident of that country contribute to such valid business nexus, and should not, therefore, be treated merely as the "making and managing [of] investments" within the meaning of the good purpose test. The discretionary authority under this provision is intended to be exercised with particular cognizance of the developments in, and objectives of, international economic integration, such as that between the member countries of the European Communities and between the United States and Canada.

The provision is similar to a portion of the qualified resident definition under the Code branch tax rules, under which the Secretary of the Treasury may, in his sole discretion, treat a foreign corporation as being a qualified resident of a foreign country if the corporation establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the foreign country do not use

the treaty between the foreign country and the United States in a manner inconsistent with the purposes of the Code rule.

It appears that any corporation that would satisfy the limitation on benefits article of the proposed treaty would generally also meet the definition of "qualified resident" for branch profits tax purposes in the Code, although there are differences in the language of the two tests. For example, a Finnish corporation qualifies for treaty benefits under the treaty if there is substantial and regular trading of its principal class of stock on a recognized stock exchange, while that corporation would not meet the 1986 Act's public company test unless such company's stock were *primarily* traded on an established securities market (or the corporation were wholly owned by another corporation whose stock were primarily so traded). It may be that, for practical purposes, those tests could be interpreted in substantially the same fashion. Also, although it is unlikely, a Finnish corporation that met the good business purpose test might conceivably fail whatever tests the Secretary promulgated under Code section 884(e)(4)(C).

Article 17. Artistes and Sportsmen

Like the U.S. and OECD models, the proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes" or musicians), athletes, and other sportsmen. The proposed treaty uses the term "sportsmen" in place of the model term "athletes" in order to clarify that is covers those who engage in nonathletic games and sports as well as those who engage in athletic sports and other forms of entertainment. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and are intended, in part, to prevent entertainers and sportsmen from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under this article, one country may tax an entertainer who is a resident of the other country on the income from his personal services as an entertainer in the first country during any year in which the gross receipts derived by him from such activities, including his reimbursed expenses, exceed $20,000 or its Finnish currency equivalent. (As discussed below, the competent authorities may under certain circumstances adjust this threshold.) Thus, if a Finnish entertainer maintained no fixed base in the United States and performed (as an independent contractor) for one day of a taxable year in the United States for total compensation of $2,000, the United States could not tax that income. If, however, that entertainer's total compensation were $30,000, the full $30,000 (less appropriate deductions) would be subject to U.S. tax. This provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit. *See* Article 23 (Relief from Double Taxation) below.).

The proposed treaty provides that where income in respect of activities exercised by an entertainer or sportsman in his capacity as such accrues not to the entertainer or sportsman, but to another person, that income will be taxable by the country in which the activities are exercised unless it is established that neither the enter-

tainer or sportsman nor persons related to him participate directly or indirectly in the profits of that other person in any manner, including the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income, or other income distributions. (This provision applies notwithstanding the business profits and personal service articles (Articles 7, 14, and 15)). This provision prevents highly paid performers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

The foregoing provisions are similar to provisions in the U.S. and OECD model treaty articles dealing with entertainers and athletes.

Article 18. Pensions, Annuities, Alimony, and Child Support

Under the proposed treaty, pensions and other similar remuneration beneficially derived by a resident of either country in consideration of past employment are subject to tax only in the recipient's country of residence. This rule is subject to the provisions of Article 19 (Government Service). Thus, it does not apply, for example in the case of pensions paid to a resident of one country attributable to services performed for government entities of the other unless the resident of the first country is also a national of the first country.

Pensions and other payments under the social security legislation of a treaty country (and other public pensions of the United States) paid by one country to an individual who is a resident of the other country or to a U.S. citizen will be taxable only in the paying country. This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on Finnish social security payments. Under this rule, only the United States may tax U.S. social security payments to U.S. persons residing in Finland. The rule thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in Finland from double taxation.

The proposed treaty also provides that annuities may be taxed only in the country of residence of the person who beneficially derives them. Annuities are defined as a stated sum paid periodically at stated times during life or a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services).

The proposed treaty contains special rules for alimony and child support. Following the U.S. model treaty, the proposed treaty exempts alimony from tax at source. The term "alimony" as used in the article means periodic payments (made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support) that are taxable to the recipient under the laws of the country of which he is a resident.

Periodic payments for the support of a minor child made by a resident of one country to a resident of the other country pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support may be taxed only in the first country under the proposed treaty.

Article 19. Government Service

The proposed treaty contains the standard provision that generally exempts the wages of employees of one of the countries from tax by the other country.

Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) will generally be taxable in that country only. However, such remuneration will be taxable only in the other country (the country not the payor) if the services are rendered in that other country and the individual is a resident of that other country who either (1) is a national of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, Finland would not tax the compensation of a U.S. citizen and resident who is in Finland to perform services for the U.S. Government and the United States would not tax the compensation of a Finnish citizen and resident who performs services for the U.S. Government in Finland.

Any pension paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) will generally be taxable only in that country. However, such pensions will be taxable only in the other country if the individual is both a resident and a national of that other country.

In the situations described above, the U.S. model treaty allows exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), and 18 (Pensions, Annuities, Alimony, and Child Support) will apply to remuneration and pensions for services rendered in connection with the business.

This provision is generally excluded from the saving clause.

Article 20. Students and Trainees

The treatment afforded students and trainees under the proposed treaty is the same as the treatment afforded them under the U.S. model treaty. This represents a departure from the present treaty. Under the proposed treaty, a resident of one country who becomes a student, apprentice, or business trainee in the other country for his or her full-time education or training will be exempt from tax in the host country on payments received for maintenance, education, or training, if the payments arise from sources outside the host country. This provision is excluded from the saving clause with respect to individuals who are neither citizens or lawful permanent residents in the host country.

The present treaty provides much more protection from host country taxation, not only to students and trainees, but also to teachers. The provisions of the present treaty do not represent the current preferred U.S. treaty policy. They exempt teachers and researchers who visit the host country for 2 years or less from host country tax on income from teaching and research; they also

exempt from host country tax certain employment income that students and trainees visiting for specifically limited periods of time may earn there.

Article 21. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Finland. Thus, it applies to income from third countries as well as to income from the United States and Finland. This article is substantially identical to the corresponding article in the U.S. model treaty.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country will be taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income sourced in a third country and paid to a resident of the United States. This article is subject to the saving clause, so U.S. citizens who are Finnish residents would continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to Finland.

The general rule just stated does not apply if the recipient of the income (other than income from immovable property (Article 6)) is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base, and the right or property in respect of which the income is paid is effectively connected with the permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, will apply. The prohibition on taxation by the country other than the residence country does apply, however, to income from immovable property that such country is not given permission to tax under Article 6. An example of such income is income from real property located in a third country.

Article 22. Capital

Many countries impose a tax on capital in addition to imposing a tax on income. As a general rule, capital taxes are imposed when the income from the capital would be taxed by the other country imposing the capital tax. The United States does not currently impose a capital tax; however, Finland does. Under Article 2 (Taxes Covered), the Finnish capital tax is a covered tax. Article 22 therefore applies to the Finnish capital tax.

Under the proposed treaty, capital may be taxed by the country in which located if it is real property owned by a resident of either country (as that term is defined in article 6 (Income from Immovable (Real) Property). Shares or other corporate rights in a company, the ownership of which entitles a person to the enjoyment of immovable property held by the company, may be taxed by the situs country of the immovable property. Personal property forming part of the business property of a permanent establishment or fixed base maintained by a resident of the other country may be taxed by the country in which the permanent establishment or fixed base is located. The owner's country of residence could also

tax that property. The right to tax ships, aircraft, containers, and assets (other than immovable property) pertaining to the operation such ships or aircraft belongs exclusively to the country in which the owner resides. All other capital would be taxable only in the country of residence.

This article is similar to Article 17 of the present treaty and to the U.S. and OECD model treaties.

Article 23. Relief from Double Taxation

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation is generally computed on a worldwide consolidated basis. Hence, subject to the separate limitation rules described below, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

The limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90 percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

An indirect or "deemed-paid" credit is also provided. A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on busi-

ness income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income. This article provides further relief where both Finland and the United States would otherwise still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

The present treaty provides separate rules for relief from double taxation for the United States and Finland. The present treaty generally provides for relief from double taxation of U.S. residents and citizens by the United States permitting a credit against its tax for the appropriate amount of taxes paid to Finland on income from Finnish sources. The present treaty generally provides for corresponding relief from double taxation of Finnish residents by Finland. However, Finland exempts from its tax certain dividends paid by a U.S corporation to a Finnish corporation.

With some modifications, the proposed treaty retains the system of the present treaty. The modifications include narrowing the class of U.S. source portfolio dividends for which Finland must grant an exemption, and providing rules applicable to U.S. citizens resident in Finland and Finnish nationals who are individuals resident in the United States.

United States

The proposed treaty contains a provision under which the United States allows a citizen or resident a foreign tax credit for income taxes imposed by Finland. The credit is to be computed in accordance with the provisions of and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the "general principles hereof"). This provision is similar to that found in many U.S. income tax treaties.

The proposed treaty also allows the U.S. deemed paid credit to U.S. corporate shareholders of Finnish companies receiving dividends from those companies if the U.S. company owns 10 percent or more of the voting stock of the Finnish company.

The double taxation article provides that Finnish taxes covered by the treaty (Article 2 (Taxes Covered)) are to be considered income taxes for purposes of the U.S. foreign tax credit. Unlike the U.S. model treaty and the present treaty, the proposed treaty does not contain the rule that credits allowed solely by reason of this article, when added to otherwise allowable credits for taxes covered by the treaty, may not in any taxable year exceed that proportion of the U.S. tax on income that Finnish source taxable income bears to total taxable income. Thus, any credit allowed solely by the treaty and not by the Code alone (e.g., a credit for the Finnish capital tax) could be used to offset U.S. tax on income from third-country foreign sources. Of the covered taxes under the treaties, apparently only the capital tax would not be creditable for U.S. Code purposes. Thus, there are no credits allowed by treaty that are not allowed by the Code, unless the proposed treaty is interpreted to

provide a U.S. foreign income tax credit for the capital tax. The staff understands, however, that there was no such intention to allow Finnish capital tax to be creditable against U.S. income tax, and that the proposed treaty should not be interpreted to allow such a credit.

Finland

The general rule in the proposed treaty for Finnish residents is that if, under the treaty, the United States may tax an item of income or capital (other than solely by reason of U.S. citizenship), then Finland will allow as a deduction from tax on that income (i.e., a credit) the amount of income tax paid in the United States, and will allow as a deduction from tax on that capital the amount of capital tax paid in the United States. In either case, the deduction is not to exceed the amount of the Finnish tax, as computed before the credit, which is attributable to the income or capital of the Finnish taxpayer that is taxable in the United States. Thus, Finland will credit U.S. tax paid by a Finnish resident (other than solely by reason of U.S. citizenship) up to the amount of the Finnish tax that would otherwise be imposed on the income that attracted the U.S. tax.

In the case of dividends paid by a U.S. resident company to a Finnish resident company, Finland will exempt the dividends from Finnish tax if the Finnish company owns directly at least 10 percent of the payor's voting shares. The exemption applies to dividends including those paid by RICs. The proposed treaty allows Finland to employ an "exemption with progression" method with respect to such income. Under the exemption with progression method such income, while exempt from Finnish tax, may be taken into the Finnish tax base for purposes of determining Finnish tax on non-exempt income.

Other rules

In this article, the proposed treaty also provides source rules for determining when an item of income arises in one of the countries. These source rules are used for the purpose of allowing relief from double taxation under this Article. Under normal U.S. concepts, these source rules will not supersede the U.S. source of income rules for purposes of internal U.S. law (including, for example, Code sec. 904(g)).

The proposed treaty's general source rule is that an item of income of a resident of one country that may be taxed in the other country under the treaty is considered to arise in that other country. (This rule does not apply, however, to income derived by a treaty country resident taxable in the other country solely by reason of citizenship in that other country.) Accordingly, income taxes paid to that other country on that income will generally be creditable (subject to any relevant limitations) in the country of residence. An item of income derived by a resident of one country that may not be taxed in the other country under the treaty will be deemed to arise in the residence country.

The proposed treaty contains special rules for U.S. citizens who are residents of Finland, and individual Finnish nationals resident in the United States. In the first case, Finland will, under the rules

set forth above, permit the U.S. citizen a credit against Finnish tax imposed on income that arises in the United States. In addition, the United States will allow the citizen a credit against his U.S. tax for any tax paid to Finland after Finland has allowed the credit for U.S. taxes. The credit comes after the Finnish tax is reduced by the deduction of U.S. taxes. The proposed treaty provides for a limited resourcing of income to give effect to this credit.

In the second case, where an individual Finnish national is resident in the United States, if the individual is considered by Finland to be a Finnish resident for purposes of the taxes covered by the treaty, then Finland reserves its right to tax that individual in Finland. However, Finland will allow a credit to such a person, as described above, for any U.S. tax on his income or capital.

Article 24. Non-Discrimination

The proposed treaty contains a comprehensive non-discrimination article relating to all taxes of every kind imposed at the national, state, or local level. It is similar to the non-discrimination article in the U.S. model treaty and the present treaty and to provisions that have been embodied in other recent U.S. income tax treaties. The non-discrimination article of the proposed treaty differs from the U.S. model in protecting all legal persons deriving their status as such from the United States, not only U.S. citizens. In this regard, the non-discrimination article of the proposed treaty more closely resembles that of the OECD model treaty.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its citizens in the same circumstances. This provision applies whether or not the nationals in question are residents of the United States or Finland. A U.S. citizen who is not a resident of the United States and a Finnish national who is not a resident of the United States are not deemed to be in the same circumstances for U.S. tax purposes.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprise carrying on the same activities. Consistent with the U.S. and OECD model treaties, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents. Nor does this article oblige a treaty country to grant a company with a permanent establishment in that country a deduction from the profits attributable to the permanent establishment for any portion of the dividends paid by that company.

Each country is required (subject to the arm's-length pricing rules of Articles 9(1) (Associated Enterprises), 11(5) (Interest), and 12(6) (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses, research and development expenses, and other expenses incurred for the

benefit of a group of related enterprises. For purposes of capital taxes, debts that are owed residents of the other country are to be deductible to the extent that they would be deductible if owed to a resident of the country of residence of the obligor.

The rule of nondiscrimination also applies to enterprises of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement which is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

The article clarifies that it does not prevent imposition of branch profits tax permitted by the Dividends article (Article 10(6)).

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to the nondiscrimination article.

Article 25. Mutual Agreement Procedure

The proposed treaty contains the standard U.S. model treaty mutual agreement provision, with some variation, which authorizes the competent authorities of the United States and Finland to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under this article, a resident of one country who considers that the action of one or both of the countries will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The competent authority will then make a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the treaty. The provision requires a waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, contains its own limitations period, providing that the competent authority of the country requested to provide a refund must have received notification that a case exists within 6 years from the end of the taxable year to which the case relates.

The six-year limitation on notification of the competent authority as to a result not in accordance with the treaty is not the preferred U.S. treaty position nor is it in the present Finnish treaty. It is similar, however, to a provision in the U.S.-Canada income tax treaty. The OECD model treaty includes a three-year limitation on the time that may lapse between the first notification of the action resulting in taxation not in accordance with the treaty, and the

presentation of the case to the competent authority. However, that time limitation generally cannot run until the taxpayer is formally on notice that a problem exists. Under the proposed treaty, no refund can be required unless there is some reason to believe that a refund case will exist before the end of 6 years from the tax year in question.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty.

Like the U.S. model treaty, the proposed treaty makes express provision for competent authorities to mutually agree on the allocation of income, deductions, credits, or allowances, the determination of the source of income, the characterization of particular items of income, the common meaning of a term, the application of penalties, fines, and interest under internal law, increases (where appropriate in light of economic or monetary developments) in the dollar threshold in the artistes and sportsmen article provision, and the elimination of double taxation in cases not provided for in the treaty.

Article 26. Exchange of Information and Administrative Assistance

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or of the domestic laws of the two countries concerning taxes to which the treaty applies insofar as the taxation under those domestic laws is not contrary to the treaty. The exchange of information is not restricted by Article 1 (General Scope). Therefore, third-country residents will be covered. In addition, the exchange of information applies to all national taxes imposed by either country, whether or not covered by the treaty.

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the treaty applies. Such persons or authorities can use the information for such purposes only. Persons involved in the administration of taxes include legislative bodies, such as, for example, the tax-writing committees of Congress and the U.S. General Accounting Office, for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

The proposed treaty contains limitations on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with the law and adminis-

trative practice of either country, or to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Upon an appropriate request for information, the requested country is to obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that the provision be strictly reciprocal. For example, once the Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the U.S. investigators can no longer use an administrative summons to obtain information. If, however, Finland could still use administrative processes to obtain requested information, it would be expected to do so even though the United States could not. The United States could not, however, tell Finland which of its procedures to use.

Where specifically requested by the competent authority of one country, the competent authority of the other country shall, if possible, provide the information in the form requested. Specifically, the competent authority of the second country will provide depositions of witnesses and copies of unedited documents (including books, papers, statements, accounts, and writings) to the extent that they can be obtained under the laws and practices of the second country in the enforcement of its own tax laws.

The proposed treaty further provides that the countries are to endeavor to collect such tax on behalf of the other country as may be necessary to ensure that benefits of the treaty are not going to persons not entitled to those benefits. This provision is carried over from the present treaty with minor modifications. It is also similar to the corresponding provision of the U.S. model treaty.

As is true of the U.S. model treaty and the present treaty, the collection provision does not impose on either treaty country the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes, or that would be contrary to its sovereignty, security, or public policy.

Article 27. Members of Diplomatic Missions and Consular Posts

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply to this article, so that, for example, U.S. diplomats who are considered Finnish residents may be protected from Finnish tax.

Article 28. Entry Into Force

The proposed treaty is subject to ratification, acceptance, or approval in accordance with the applicable procedures of each country and the government of each treaty country will notify the other as soon as possible that those procedures have been complied with. The proposed treaty will enter into force 30 days after the later of these notifications.

With respect to Finnish taxes withheld at source, the proposed treaty will be effective for income derived on or after January 1 in the calendar year next following the year in which the treaty enters into force. With respect to other Finnish income taxes and taxes on capital, the treaty is to be effective for taxes chargeable for any taxable year beginning on or after January 1 in the calendar year next following the year in which the treaty enters into force.

With respect to U.S. taxes withheld at source, the proposed treaty will be effective for amounts paid or credited on or after the first day of the second month following the date on the which the treaty enters into force. With respect to other U.S. taxes, the treaty is to be effective for taxable years beginning on or after the first day of January next following the date on which the treaty enters into force.

Following the last day on which the present treaty has effect in accordance with these effective dates, that treaty will terminate.

Article 29. Termination

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it by giving written notice through diplomatic channels at least six months before the end of any calendar year following after the period of five years from the date of its entry into force.

A termination will be effective with respect to Finnish taxes withheld at source on income derived on or after January 1 in the calendar year next following the year in which the notice is given. With respect to other Finnish income taxes and taxes on capital, a termination will be effective for taxes chargeable for any taxable year beginning on or after January 1 in the calendar year next following the year in which the notice is given.

With respect to U.S. taxes withheld at source, a termination will be effective for amounts paid or credited on or after the first day of January next following the expiration of the six month period. With respect to other U.S. taxes, a termination is to be effective for taxable years beginning on or after the first day of January next following the expiration of the six month period.

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